CHART OF THE MONTH

DECEMBER 2012

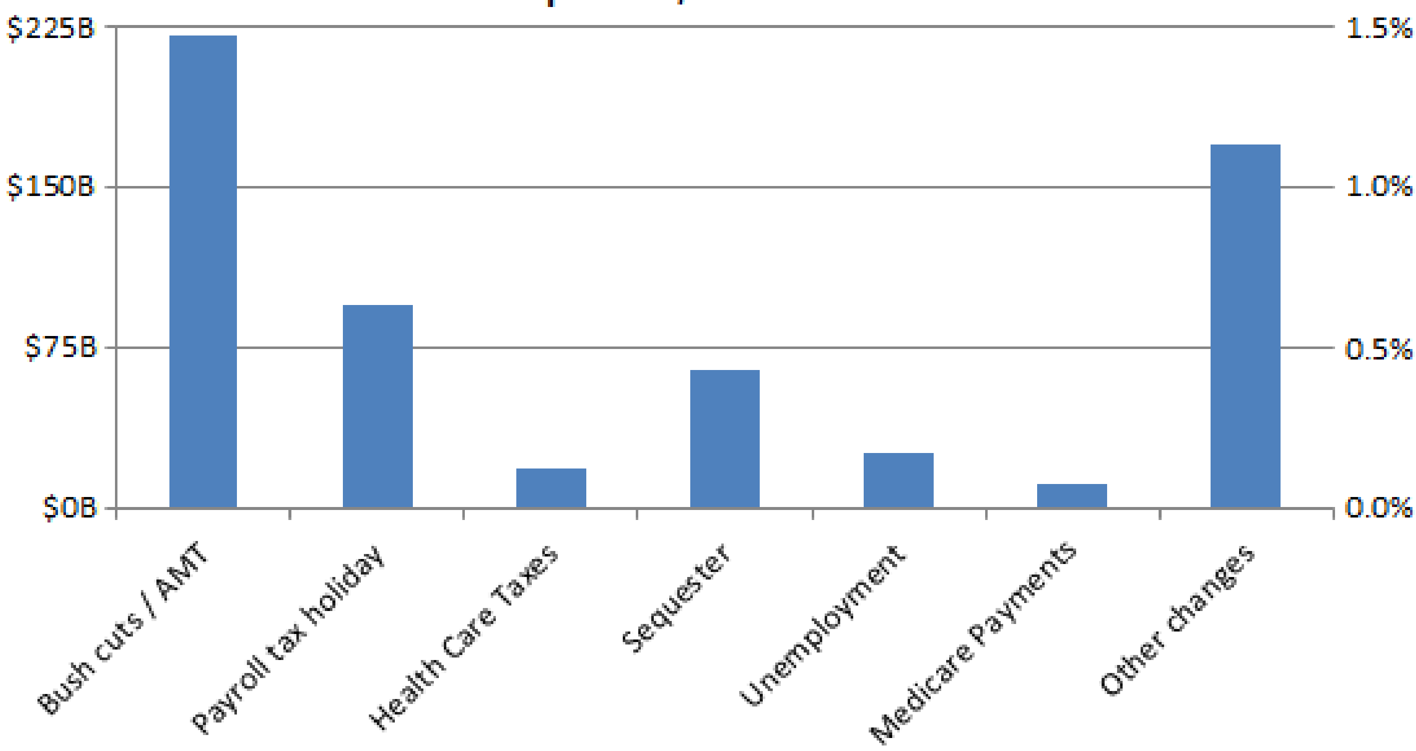
President Obama and members of Congress return to Capitol Hill today to restart negotiations designed to avoid the "fiscal cliff," which entails across-the-board tax increases and indiscriminate reductions in government spending, effective January 1, 2013. No matter the outcome, any tax hikes or spending cuts will generate a fiscal drag to the economy, negatively impacting the growth of the Gross Domestic Product (GDP).

As shown in the bar chart below, the major elements of the fiscal tightening to take effect next year under the current law total approximately $600 billion, which amounts to 4% of GDP. If the so-called Bush tax cuts, payroll tax holiday, and extension of the unemployment benefits expired in full, coupled with mandatory cuts in military and other government spending, economic growth would likely recede from its current run rate of 2% to a *negative* 2%.

While we're skeptical that a bipartisan deal can be made in the next few days, we believe the financial markets could put pressure on lawmakers to reach a temporary fix early next year with perhaps a more comprehensive "grand bargain" that deals with major tax reform and entitlement spending to follow.

If the truth be told, neither tax increases or spending decreases will solve the deficit and debt problems in and of themselves. Instead, the focus needs to be on growing the economy, which will create more jobs, more tax revenues, and less spending on safety nets, such as unemployment benefits, food stamps, welfare, etc. Nonetheless, it is all but certain that there will be some fiscal drag in the short run, suggesting that economic growth will remain sluggish for the foreseeable future.

FISCAL DRAG PROJECTIONS
Impact in $ and % of GDP



Source: Congressional Budget Office

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